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THE FEDERAL CORPORATION TAX

I

At the opening of the Sixty-first Congress, the Taft administration, supported by a large Republican majority in both houses, was strongly committeed to an honest and general revision of the tariff downward.[1] In order that Congress might undertake this revision at an early date President Taft stated in his inaugural nessage that he had determined to call an extra session to meet March 15, 1909, and that should it be found impossible to secure sufficient revenue for the adequate support of the government from the taxes then in use, and at the same time fulfill the pre-election promises, then "new kinds of taxation must be adopted, and among these I recommend a graduated inheritance tax as correct in principle and certain and easy of collection."[2] In his message to Congress at the beginning of the special session the President estimated that the annual deficit would approximate $100,000,000 and again suggested an inheritance tax as an appropriate source of additional revenue.

While the administration was thus committed to a national inheritance tax, other important interests represented in Congress were even more insistent upon a national income tax, with the double purpose of providing revenue to take the place of losses resulting from the expected downward revision of the tariff, and of throwing a larger share of the burdens of government upon the wealthier classes. The demand for a national income tax for the latter purpose had earlier found concrete expression in the short-lived act of 1894,[3] which, like the corporation tax, was made a part and parcel of tariff legislation. The decision of the Supreme

[1] *Cong. Rec.*, 44:2489, 4721, 4753, 4786, and *passim.*

[2] *Cong. Rec.*, 44:3.

[3] *U. S. Statutes at Large*, 28:553. The income tax of 1861 was a war measure, forced upon Congress by the pressing need for revenue and, in the hope that other and more acceptable forms of taxation might be found, its enforcement was postponed until July 1, 1862. See *Annual Report of the Secretary of the Treasury* for 1861.

Court holding the income tax act of 1894 unconstitutional[4] was followed by an even stronger and more persistent demand for an income tax that would stand the test of the court. This agitation expressed itself both through the introduction of income tax bills into Congress for the purpose of keeping the subject before the people, and through the various proposals to amend the federal constitution in such a way that a national income tax would be approved by the Supreme Court. With the latter purpose in view, during the period 1896-1909, a considerable number of the State legislatures memorialized Congress to propose such an amendment and in 1908 the Democratic party made the income tax a prominent feature of its national party platform.[5]

The administration's program was carried through the House of Representatives without apparent difficulty. The inheritance tax proposed by the President was incorporated into the general tariff bill, and in this form came before the Senate for general discussion. In the upper house the inheritance tax met with little favor. The Committee on Finance to which the bill was referred recommended that this feature be struck out,[6] and in the words of Senator Root "no voice was raised" in its favor except that of Senator Dixon of Montana.[7] In the meantime, two income tax amendments to the general tariff bill were offered, one by Senator Bailey of Texas and the other by Senator Cummins of Iowa. While these two measures differed in character it was apparent, to quote Senator Root, that the income tax "would in the ordinary course of affairs receive a majority of the votes of the Senate."[8] The administration was not unprepared for this possibility. In his address at Cincinnati, July 28, 1908, accepting the Republican nomination for the presidency, Mr. Taft said that in his judgment an amendment to the constitution was not necessary in order to devise an income tax.[9] Immediately upon his inauguration accord-

[4] Pollock v. Farmers' Loan & Trust Co., 157 U. S. 429.

[5] "We favor an income tax as a part of the revenue system and we urge the submission of a constitutional amendment specifically authorizing Congress to levy and collect a tax on individuals and corporations to the end that wealth may bear its proportional share of the burdens of government." *Cong. Rec.*, 44:3309.

[6] *Cong. Rec.*, 44:4002.

[7] *Cong. Rec.*, 44:4002.

[8] *Cong. Rec.*, 44:4002.

[9] *Cong. Rec.*, 44:4002, 4717.

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ing to both Mr. Longworth[10] and Senator Root,[11] the President requested the Attorney General to "study the income tax decisions and prepare the draft of a law which would, in his opinion, serve as an equivalent and conform to the constitution." This draft was submitted to the Ways and Means Committee of the House of Representatives by Mr. Longworth of Ohio, and there slept in the files of the committee until the income tax propaganda seemed likely to stampede the conservative Senate. On June 16, 1909, President Taft sent a special message to the upper Chamber calling attention to the probable unconstitutionality of the income tax propositions then before it, and recommending, first, an amendment to the constitution permitting Congress to levy and collect income taxes; and second, the federal corporation tax, above referred to, as a feasible substitute. The consideration of the tariff schedules was completed on June 29, and immediately thereafter Senator Aldrich of the Finance Committee offered the federal corporation tax as a substitute for the income tax amendment which was next in order upon the calendar. In the discussion which followed, the origin of the corporation tax was fully disclosed and the reasons for its adoption as an administration measure briefly stated. According to Senator Flint, who had charge of the measure in the Senate, the Finance Committee had "no pride of opinion as to its form," for the reason that the bill was drawn by the Attorney General after conference with the President and Senator Root,[12] and that the committee had made certain amendments and changes only. Both Senator Root[13] and Senator Aldrich[14] confirmed Senator Flint's statement in all its important particulars.

mind before his inauguration and that he asked for the opinion of many well known economists upon the subject. Immediately after his inauguration he required to be drawn up by the Attorney General a corporation tax measure, substantially identical with the one that is before us now."

[10] *Cong. Rec.*, 44:4002, 4717.

Mr. Clayton: "And you think your party intend to make it a part of your fiscal policy?"

Mr. Longworth: "I do. There is one man and one man only who is responsible for this corporation tax and to whom if it shall become part of our permanent law, the credit is due, and that is the President of the United States."

[11] *Cong. Rec.*, 44:4002.

[12] *Cong. Rec.*, 44:3937.

[13] "I had here a few days ago the paper which he (Rep. Longworth) presented. It bore the file mark of the Committee on Ways and Means in one of the early days of April. It bore upon its face corrections in the hand-

In the discussion of the bill comparatively little attention was given to its detailed provisions. It was supported for various reasons, of which the following are the more important.

First, it would produce revenue at once and thus facilitate the continuance of the high tariff system.

Second, it was, in the minds of some, a substitute for an income tax, which, in the words of Senator Aldrich, "is sure in the end to destroy the protective system."[15]

Third, it was also favored by many who believed in the income tax as a permanent feature of our tax system, but who feared that such a tax would, until the constitution should be amended, be declared unconstitutional. Moreover there was no certainty

writing of the Attorney-General and blanks filled in in the handwriting of the President. It was presented to the committee as a suggestion of a measure which, if the Congress preferred, might be substituted for the inheritance tax already recommended by the President; or which, if it were found necessary to raise more revenue, might be added to the inheritance tax.

"That paper, with some light development and adaptation to the conditions and the statutes, is now before us in the measure called the 'corporation tax substitute.'

"The Committee on Ways and Means preferred the inheritance tax. They did not deem it necessary to add to that a tax upon the income or upon the business of corporations. Accordingly the suggestions slept in the files of the committee. The bill came to the Senate. It was reported by the Senate Committee on Finance, and their report struck out from the bill the inheritance-tax provision which the House had included. Thereupon two of the most able and distinguished members of this body, one from each party, presented a general income tax amendment. No voice was raised in favor of the inheritance tax. So far as I recall, no voice has been raised except in the very luminous and interesting address of the Senator from Montana (Mr. Dixon) day before yesterday.

"It was apparent that the measures introduced thus almost contemporaneously from the Democratic side and from the Republican side of this chamber would, in the ordinary course of affairs, receive a majority of the votes of the Senate. Under those circumstances with the Senate apparently by common consent disapproving the inheritance tax, with the Senate apparently ready by a majority to approve the general income tax, the President sent to the Senate a message in which he recommended for our adoption the same provision for a tax upon the business of corporations which he had already suggested to the Committee on Ways and Means of the House. He did that, sir, of course, because in his judgment it was better for the country that the tax upon the business of corporations should be incorporated in our law than that the general income tax should be incorporated in our law." Senator Root, *Cong. Rec.*, 44:4002.

[14] *Cong. Rec.*, 44:3929-30.

[15] *Cong. Rec.*, 44:3929.

Court holding the income tax act of 1894 unconstitutional[4] was followed by an even stronger and more persistent demand for an income tax that would stand the test of the court. This agitation expressed itself both through the introduction of income tax bills into Congress for the purpose of keeping the subject before the people, and through the various proposals to amend the federal constitution in such a way that a national income tax would be approved by the Supreme Court. With the latter purpose in view, during the period 1896-1909, a considerable number of the State legislatures memorialized Congress to propose such an amendment and in 1908 the Democratic party made the income tax a prominent feature of its national party platform.[5]

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a second and still more stinging rejoinder. Notwithstanding the serious and weighty objections thus raised to the provisions of the bill, no attempt was made to change its phraseology and the bill became a law, practically as introduced, by the approval of both houses, and the signature of the President, on August 5, 1909.

II

The act imposes a tax of one per cent upon the "entire net income over and above $5,000, received by it each of the several corporations subject to the tax) from all sources" during each year, exclusive of amounts received as dividends from other corporations. The tax is thus imposed upon the net corporate income (with exception noted above). If Congress had not attempted to define net income, an opportunity would have been presented calling for the determination in an authoritative way of the scientific meaning of this controverted term.[20] But the framers of the bill and those responsible for its phraseology during its consideration by Congress had ideas of their own upon this subject, and as a result the Federal Congress attempted to lay down for the business world hard and fast definitions of the terms used. "Such net income," the act states,[21] "shall be ascertained by taking from the gross amount of the income received during the year:

"First, all the ordinary and necessary expenses actually paid within the year out of the income in the maintenance and operation of its business and property....

"Second, all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation....

"Third, interest actually paid during the year on its bonded and other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid up capital stock of such corporation....

"Fourth, all sums paid by it within the year for taxes....

"Fifth, all sums received by it within the year as dividends upon the stock of other corporations subject to the tax hereby imposed...."

The accountants in their letter of July 8 to the Attorney General and to members of Congress asserted that the above provisions "violated all the principles of sound accounting," and stated that in their opinion the proper deductions should be:

"First, expenses actually incurred, because the payment is not necessarily made in the year in which the expense is incurred.

[20] Walton "Earnings and Income," *Journal of Accountancy*, vol. 6, p. 6. Dickinson "The Profits of a Corporation," *Official Record, Congress of Accountants, 1904*, p. 171.

"Second, losses actually ascertained, because losses may be incurred and the amount may not be ascertained until a subsequent period.

"Third, interest actually accrued, because interest is never paid until the end of the period during which it accrues, and the interest accrued is the proper charge against income."[21]

The statements of the accountants were plain and explicit. They were simply applying to a concrete case certain well-known and generally accepted principles of economic science as carried out in actual practice by every public accountant worthy of the name in the accounts of all modern industrial, commercial, and railway enterprises. In his reply of July 12, the Attorney General gave an equally full and explicit statement of the theory upon which the act was drawn. He said "the bill was purposely framed to deal with receipts and disbursements made within the year for which the tax was to be imposed, and the words 'actually paid' were used advisedly. The same may be said with respect to losses sustained and interest actually paid. The theory of the framers of the bill in this respect differs from that which you advocate."[22] It is thus evident that the framers of the law intended to define "net income" as the excess of receipts over disbursements, and this interpretation caused the accountants to suggest in their second communication of July 21, 1909, that the term "receipts on income account" and "disbursements on income account" be substituted for income and expense, in order that the language of the act might conform to its true meaning. If this suggestion had been adopted, however, it is evident, as pointed out by the accountants, that railroads and manufacturing enterprises would have been obliged to keep duplicate books of account, and, even then, it would have been found quite impossible to ascertain the expenses paid within the year out of the income in the maintenance and operation of the business and properties.[23] A manufacturing concern, as is well known, purchases its materials in quantities on credit and pays for them in cash or its equivalent at a later date. Some of the materials thus purchased may be used immediately, some may be kept for years. Some of the materials are used to extend the plant and some are turned into finished goods and sold. When such materials are taken from the warehouse, they are charged

[21] *The Corporation Tax Law of 1909.* A letter to the members of the American Association of Public Accountants, etc., Sept. 30, 1909, p. 10.

[22] *Letter of the Attorney General to the Accountants,* July 12, 1909, Parag. 4.

[23] *The Corporation Tax Law of 1909,* etc., p. 17.

against the proper account, capital or expense, as the case may be. During the same day, materials will thus be drawn from the warehouse, some of which have already been paid for and some of which may be paid for long after the articles made from them have been sold and the collections made. [24]

Notwithstanding the clearness with which these elementary principles of accounting were set forth, the authorities at Washington, including the Attorney General, remained incredulous and obdurate, and the federal corporation law, "a curious combination of the archaic and modern,"[25] was turned over in its original form to the treasury department for practical administration.

III

It was fortunate both for the administration and for the legitimate corporate interests of the country that the Secretary of the Treasury was at this time a man whose business experience enabled him to understand the difficulties to which the accountants had called the attention of the Attorney General and Congress in vain. Immediately after the corporation tax bill became a law, the Commissioner of Internal Revenue under the general direction of the Secretary of the Treasury began the work of formulating the regulations and preparing the blanks for the purpose of making the assessment and collecting the first year's tax. When these regulations and forms appeared on December 3, 1909, it was found that the representations of the accountants had borne fruit, not indeed in the exact form hoped for, namely a change in the phraseology which would make the requirements conform to the standard set by modern accounting practice, but by grace of administrative rulings defining "gross income," "net income," and specifying with considerable detail the methods by which each of the several classes of deductions was to be made.[26] Thus "gross income received" as defined by the administrative regulations was to be ascertained

[24] "There is in our opinion no method in which such a statement as that called for in the proposed law can be prepared short of an entirely independent separate set of books, designed to follow each bill paid through to the ultimate destination of the materials and services required thereby, thus duplicating the present cost of the accounting department, and serving no useful purpose whatever." *The Corporation Tax Law of 1909,* p. 17.

[25] *The Corporation Tax Law of 1909.* Letter of President Sterrett to the American Ass'n of Public Accountants, p. 3.

[26] *Regulations,* No. 31, Internal Revenue, Dec. 3, 1909.

"through an accounting showing the difference between the price received for the goods as sold and the cost of such goods as manufactured," and not, as stated by the Attorney General in his first letter to the accountants, "actual receipts from sales for the year." The cost of manufacturing was to be found by adding to the labor cost the value of materials used during the period, determined by the inventory method, rather than the value of materials paid for during the year, as suggested in the same letter. In ascertaining expenses, materials and supplies were to be deducted only to the amount actually used in the operation and maintenance of property during the year. Gross income, it was pointed out in the regulations, is "practically the same as gross profits,"[27] but in addition includes all amounts received from outside sources. Moreover to make it absolutely certain that gross income was to be found by the usual accounting methods, the following comprehensive statement was added: "It is immaterial whether any item of gross income is evidenced by cash receipts during the year or in such other manner as would entitle it to proper entry on the books of the corporation from January 1 to December 31, for the year in which the return is to be made."[28]

The treasury regulations thus opened up anew the question of inventories which had caused the accountants to state that in cases where the fiscal year of any corporation failed to conform with the calendar year "it would be quite impossible.... to make a true return of the profits."[29] It is, of course, well known that some corporations keep a perpetual inventory,[30] partly for the purpose of protecting stock against loss by petty thieving. The perpetual inventory is, however, expensive, requiring that the cost of all individual sales be calculated and the sum of such costs be totalled daily, or that the same process be applied to each class of goods by showing the quantity of stock at the beginning, the quantities purchased, and the quantities withdrawn. Unless a perpetual inventory is a necessity of the business, therefore, most corporations take the inventory periodically, usually once a year, the date

[27] *Regulations,* No. 31, Internal Revenue, p. 9.
[28] *Ibid.,* pp. 7-9.
[29] *The Corporation Tax Law of 1909.* A letter etc., p. 13.
[30]

	Stock at beginning	Purchases	Total	Sales	Stock at end
Dec. 31...	$400,000	15,000	415,000	12,000	403,000
Jan. 1....	403,000	12,000	415,000	10,000	405,000

chosen being the end of the fiscal period. The gross profit for the year is then determined in the following manner:

CORPORATION A.

Gross Income 1910

Inventory January 1	$1,000,000	Sales	$14,000,000
Purchases, January 1 to December 31	9,000,000	Less returns and deductions	100,000
Total	10,000,000	Net Sales	$13,900,000
Deduct Inventory Dec. 31	900,000		
Cost of Materials	9,100,000		
Gross Profit	4,800,000		
	$13,900,000		$13,900,000

Since an inventory is necessary at the beginning as well as at the end of any period for which the income is to be obtained, and, since the tax was to be assessed for the year 1909, the law thus made it necessary for all corporations to furnish an inventory as of December 31, 1908, some months before the corporation tax was even proposed. On account of the practical impossibility of taking a real inventory, the regulations permitted an estimated inventory to be furnished. Under the circumstances the inventory would naturally be found in the following way, namely: to the inventory for the nearest date before December 31, 1908, add the purchases from the date of inventory to the end of the year, and subtract the estimated cost of all goods sold during the same period. If the estimated cost of the goods is the real cost, the estimated inventory will then be identical with the real inventory as it would appear, had the stock actually been taken December 31, 1908, provided that no changes had taken place in the market price of the goods. Any change in the market price of the goods inventoried would necessitate a further correction to allow for differences in value on that account. It is, of course, evident that under these circumstances the inventory would be an estimate, and that the larger the inventory on January 1, 1909, the less the income and consequently the less the tax.

After August 5, 1909, all inventories are assumed to be taken in the usual method, although there seems to be no requirement to that effect, and hence the difficulty referred to above will occur but once. The requirement of an inventory at the end of each calendar year is, however likely to cause unnecessary expense in some cases, and to interrupt business seriously in others. It is well known that retail mercantile establishments find the end of the

calendar year an exceedingly awkward time to take the inventory. Small mercantile establishments, however, are not generally conducted under the corporate form, and therefore the hardship imposed in this particular is confined to the larger institutions. With railways, however, the case is quite different. Practically all railways in the United States are subject to the regulations of the Interstate Commerce Commission, both as to the form of the accounts and to the date when the annual report must be drawn up. As the date provided in the regulations of the Commission is June 30, the railroads are required to take two inventories annually, or submit an estimated inventory on December 31, for the purpose of the corporation tax return. As the regulations explicitly specify that "An inventory or its equivalent must be submitted at the close of each calendar year,[31] it is probable that in few cases is there a special inventory taken for this purpose. In all such cases, therefore, the net profits returned are estimated profits.

Whatever the system employed, the determination of the gross income is a comparatively simple problem. It is, however, quite a different one, when the accountant seeks to find the true net income. The framers of the law evidently intended to make the process so simple that there could be no opportunity for differences of opinion. Only "the ordinary and necessary expenses actually paid," the "losses actually sustained," including a reasonable allowance for depreciation, "interest actually paid," etc., were to be deducted from the gross to find the net income. In the original regulations of December 3, 1910, the general principles on which such deductions were to be made were briefly stated. In accordance with the regulations governing gross income it was made plain that the ordinary procedure of accounting practice was to be followed; that materials, and supplies were to be charged against the year in which they were used; that expenses were to be considered paid when entered upon the books; that only such losses might be deducted as actually occurred during the year; that the depreciation charges should be based on the life of the property, its cost value and its use; and that when depreciation had been charged, expenses on the same account must be charged against depreciation account and not against gross income.

As soon as the regulations accompanied by the blanks were sent out to the corporations, questions began to be raised in regard to specific points and the answers of the Commissioner have taken the

[31] *Regulations,* No. 31, Internal Revenue, p. 11.

form of decisions and are published for the general information of the officers making the returns.[32] In general these decisions relate to the following important subjects:

First, what corporations are subject to the tax?
Second, what is capital stock?
Third, what is an expense?
Fourth, what is a proper depreciation charge?
Fifth, to what extent are the returns open to public inspection?

(1) The act explicitly states that every corporation, joint-stock company, or association, organized for profit and having a capital stock represented by shares, and every insurance company, organized or operated within the United States, shall be subject to the tax. It provides, however, that labor, agricultural, beneficiary, religious, charitable and mutual societies not conducted for profit are exempt. Under this clause, it has been held by the Commissioner that co-operative dairies "not issuing stock and allowing patrons dividends based upon butter fat, mutual savings banks having no capital stock, companies organized in Porto Rico and not engaged in business in the United States," and voting trusts are not liable under the law. On the other hand mutual hail societies are regarded as insurance companies, sugar plantations are not agricultural societies; therefore, neither are exempt. The most important ruling however, was that based upon the opinion of the Attorney General under date of February 14, 1910. The question arose in regard to certain organizations that have been particularly prominent in the express business and in the public service field, including certain organizations originating in Massachusetts. All limited partnerships, it was held, having a capital stock, even if no certificates of stock have been issued, are to be included under the organizations subject to the tax. In this decision it was recognized that capital stock and certificates of stock are not identical, and that the first may exist without the second. Under this decision, a considerable number of organizations essentially corporate in character were made subject to the tax which under a more technical decision would have escaped. This ruling lessened the strength of the charge of unjust discrimination between corporations and other competing organizations which has been generally made.[33]

[32] *Treasury Decisions,* Nos. 1578, 1588, 1606, 1672.

[33] *Chicago Corporation Tax Law Conference,* pp. 16, 27, 28, 36.

(2) The law was framed upon the theory that corporations ought to borrow no more funds than the stockholders invest. Based upon this idea, the law provided that the interest actually paid upon its bonded and other indebtedness to an amount not exceeding the paid-up capital stock might be deducted. This provision, while inserted with the best of intentions, is predestined not only to make unnecessary trouble but also to bring about an equalization of the stock and the debt, where the capital stock is smaller, by a particularly unfortunate process well known in corporation finance, namely, by watering the stock. For example, a certain well-known public service corporation has outstanding $12,000,000 in bonds and a little less than $6,000,000 in capital stock. Under the law it is permitted to deduct interest on only one half of its indebtedness. This situation is especially unjust to those which have foregone dividends in past years in order to accumulate a strong surplus. On this account a request was made to permit the surplus and undivided profits to be counted as paid-up capital stock, thus increasing the amount of bonds upon which interest might be deducted. The Commissioner has very properly held that this practice could not be sanctioned. At the same time, however, this decision added a new incentive to those already in operation in favor of inflating the capital stock account. If the corporation tax is made a permanent feature of our revenue system, a corporation with less capital stock than bonds will be in the near future a *rara avis*. In this connection the Commissioner also ruled that the par value of the stock would be held to be the paid-up capital stock except when the stock was subject to assessments. This feature will tend to hasten the extinction of assessable stocks, but will not in any way tend to prevent stock from being issued and sold below par.

(3) There is no problem connected with the determination of net income more complex in its nature or more difficult of solution than that of segregating the expenses from the other disbursements. The law states "that all of the necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties" may be deducted from the gross income in order to find the net earnings. The question "what is an expense" is still unanswered. It is obvious, of course, that while it is possible to lay down the general principles upon which the answer to this query may be given, cases will be continually

arising in which the principles must be applied and the answer must be given in specific terms. According to the principles of accounting, an investment is any expenditure of funds which remains as a permanent asset. An expense, on the contrary, yields but one return and the object for which the expense is incurred perishes in its use. Thus, expenditures occasioned by the erection of a building for the purpose of manufacturing automobiles is an investment. The same is true of machinery, tools, and office equipment. Expenditures on account of labor and materials directly used in manufacturing are, on the other hand, expenses. The law, however, makes no attempt to lay down even the general principles upon which expenses are to be separated from investments. Moreover, it does not specify particular items or classes of items that may be included in expenses. On this account the Commissioner has been called upon to decide a variety of cases, each of which constitutes a precedent, as in the case of the decisions of a common law court. These decisions may for convenience be grouped into two classes: first, those laying down general principles, and second, those deciding special cases. For example, the Commissioner has ruled that amounts expended in additions and betterments which constitute an increase in the capital investment are not proper expense items.[34] This ruling, which is found in the latest decisions, was, however, a general regulation based upon several earlier decisions in which specific cases had been under advisement.[35] Here, then, the tendency to formulate general principles only after a number of specific rulings had been handed down, is evident. It is probable that as the number of specific rulings increases, this tendency will become more and more marked.

The more important of the specific decisions relate to the use of stocks and bonds as a means of paying debts. Under this head the department has ruled, first, that commissions allowed salesmen and paid-in capital stock may be deducted as expenses when so charged on the books. Second, that proceeds from the sale of bonds when used in defraying necessary and ordinary expenses may also be included in expenses. In the latter case the ruling was evidently based upon the use of the funds without regard to their source. In the case of dividends and returns upon stock, the Commissioner adopted the opposite view, holding that dividends

[34] *Treasury Decisions*, 1675, No. 50.
[35] *Treasury Decisions*, 1606, Nos. 52-53-54.

used in paying wages would not be proper deductions as expenses. Pensions to retired employees are allowed as expenses, while gifts or gratuities are not. A further decision on the subject of wages shows that the department is prepared to question the amount paid in wages, as well as to determine whether particular wage items are proper deductions.[36] Moreover the Commissioner has held in several cases that an expense actually paid within a given year must be prorated over the period during which the use of the objects of expense was enjoyed, thus again departing from the original interpretation of the law and conforming to the principles of modern accounting practice.

(4) What is a proper allowance for depreciation[37] under specific circumstances is a problem of equal importance with that of determining operating expenses. In certain kinds of business undertakings, this problem is solved by keeping the plant and machinery in perfect repair and charging such repairs to the expense account. In most cases, however, it is impossible to use this method, first because of the impracticability of making repairs piece-meal, and second, because both plant and machinery wear out gradually and become obsolescent even though kept in perfect condition. Companies operating mines and oilwells have a wholly different set of conditions to meet. Here the deposits are assets and, as they are extracted and sold, the original property account represented by such assets is constantly growing less and less valuable until finally it wholly disappears. If no allowance were made for depreciation, the outgoing assets would swell the income account and thus be subject to the corporation tax. Since the tax is laid upon all corporations irrespective of the nature of their business, it was obviously necessary to provide for depreciation, and this open recognition of the fundamental principles upon which depreciation is based has immeasurably strengthened the hands of

[36] "When allowances on account of salary are deemed excessive and for the purpose of evading the tax, investigation will be made and if the facts warrant, prosecution will follow." *Treasury Decisions*, 1675, No. 58.

[37] Since depreciation has no place in a system of accounts based upon of allowances of this character, made it necessary to transform the entire actual receipts and disbursements, the law, by its recognition and adoption act by administrative rulings to conform to the ordinary accounting practice, or disregard this feature entirely. Fortunately the former course was adopted. *Treasury Decisions*, 1675, Nos. 44-45.

the Commissioner in the controversy with the Attorney General over the interpretation of the act.[38]

The general principles under which depreciation is allowed were briefly stated in the original regulations, and supplemented by more specific regulations in March, 1910, and February, 1911, especially in regard to minerals, oils, etc. In the supplementary regulations issued in March, 1910,[39] two features demand attention: First, where it is difficult for any reason to determine the actual depreciation in the value of railroad and mining property, annually, the depreciation may be determined for a period of years and prorated over the given period; and second, where depreciation in mines, oil and gas wells, buildings and machinery is claimed in excess of 5 per cent a detailed explanation must be furnished. In the second series of decisions[40] the regulations relating to depreciation in minerals and oils are more extended and more explicit. The business of such corporations, it is stated, comprehends two classes of gains and losses. First, the gain or loss arising from the sale of capital assets which have been held for a period of time, and second, the gain or loss resulting from the operation of the industry within a given year. In the case of corporations operating such business establishments, two distinct kinds of depreciation are allowed: First, for the actual exhaustion of the deposits, the wear and tear and obsolescence of machinery, etc., and second, an additional allowance on account of the unearned increment represented in such properties owned on January 1, 1909.[41] In order to determine the value of this unearned increment, each corporation of this character is required to make an estimate as of January 1, 1909, of the market value of the minerals, mines, etc., in the deposit. Such estimate must be on the basis of the value of the deposits in total and must then be reduced to unit value, per ton, per barrel, etc. The unit value thus found is then used to determine the value of the capital assets sold during any year, and from this value there may be deducted first, depreciation based upon the cost of

[38] "The regulations which have been issued by the Secretary of the Treasury are clearly not in conformity with the law . . . there are many of us who know there is a conflict at Washington which the President may be called upon to decide between the Treasurer and the Attorney General as to whether these regulations will hold." Henry C. Bannard, *Chicago Tax Law Conference*, p. 21.

[39] *Treasury Decisions*, 1606.

[40] *Treasury Decisions*, 1675.

[41] *Treasury Decisions*, 1675, Nos. 82-89.

capital assets sold, and second, any royalty paid on account of the minerals thus disposed of as shown in the following form:

"Value at January 1, 1909, determined in manner outlined, of minerals, etc., which may be removed and disposed of in any year subsequent thereto .....$———

Less the following:

(a) Proportion of depreciation charge applying to exhaustion of minerals disposed of, ascertained as first explained herein on basis of original cost.....$———

(b) Royalty paid, if any, on minerals disposed of....$———

Balance, being unearned increment at January 1, 1909, to be excluded from gross-income item.....$———

The balance being the unearned increment on property owned previous to January 1, 1909, deducted from the corporate gross income, gives the adjusted gross income from which the regular deductions are to be made. In making this estimate the value per unit is the important factor, since the Commissioner promises to make the proper adjustment in later years, provided the amount mined does not conform to the original estimate. The allowance for profit arising from the unearned increment applies of course only to the properties acquired before the law went into effect on January 1, 1909.[42]

(5) Finally, the law provides that the returns in the office of the Commissioner of Internal Revenue shall constitute public records and be open to inspection as such. The publicity feature of the law was favored by the President,[43] and was one of the impor-

[42] Corporation A. engaged in mining coal estimates its coal deposits at $100,000, January 1, 1909, on a basis of 100,000 tons or $1.00 per ton. The property was purchased in 1908 for $50,000 or $.50 per ton. Assuming that 10,000 tons are mined and that the coal is selling during 1909 for $1.50 per ton at the mine, and that a royalty of $.10 per ton is paid, the deduction on account of the unearned increment is found as follows:

Estimate value Jan. 1, 1909, per ton.....		$1.00
Less (a) Depreciation $1.00 less .50.....	$.50	
(b) Royalty	.10	
		.60
Unearned increment per ton.....		.40

$1.50 —.40 = 1.10.

$1.10 x 10,000 = $11,000 the gross corporation income from which the regular deductions are to be made.

[43] *Senate Document*, No. 98; 61 Cong., 1 sess.

tant factors in attracting the support of a portion of the progressive element of the Republican party in the Senate. Almost immediately after its provisions were made known, intense opposition to this feature was evidenced by the smaller corporations, especially those whose securities were not listed on the exchanges and which therefore were not accustomed to make their reports public. This opposition was brought to a focus through the activity of the Illinois Manufacturers' Association in calling a conference of industrial and commercial organizations to be held in Chicago, January 14, 1910.[44] At this conference over two hundred delegates were present, representing industrial and commercial associations from all of the important manufacturing districts in the United States. Its primary object was to secure the repeal of the publicity section of the act on the ground that it was discriminating and unfair,[45] first, as between the larger corporations and the smaller ones, and second, as between all corporations, and partnerships and individual proprietors. After a full day's discussion, resolutions were adopted condemning the law on the above grounds, calling for its repeal as a whole,[46] and in the meantime demanding especially the suspension of the publicity feature. To conduct a publicity campaign against the publicity clause and secure action on the part of Congress, a committee of eleven was appointed, which by special appointment, was heard by the authorities at Washington.[47]

Within a month after the Chicago Conference and soon after the Committee of Eleven presented their recommendations, the Commissioner issued the first decision on the administration of the publicity feature.[48] In this it was held that since Congress had made no specific appropriation for the purpose of filing the returns and keeping them open to public inspection, they would be treated as other returns made under the internal revenue act. Under this ruling, the publicity feature, was without action of Congress, practically suspended. The Illinois Manufacturers' Association in their

[44] *Chicago Corporation Tax Law Conference,* Jan. 14, 1910.

[45] *Chicago Corporation Tax Law Conference,* p. 4.

[46] *Ibid,* p. 2.

[47] Two bills had already been introduced into the House of Representatives, one (H. R. 14545) on December 14, 1909, providing for the repeal of the act in its entirety, and the other, (H. R. 17504) on January 10, 1910, amending the law by extending the time for filing the returns until May 1st annually, and striking out the last clause of section six, making the returns public records.

[48] *Treasury Decisions,* 1594, Feb. 17, 1910.

published literature[49] claim the credit for securing this administrative decision.

The burden for the failure of the publicity clause being thus thrown upon Congress, that body provided in the general appropriations, for the fiscal year 1910-11, a fund of $25,000 for the purpose of classifying, indexing and exhibiting the returns, and then threw down the glove by further providing that "any and all such returns shall be open to inspection only upon the order of the President under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President."[50] Under this authority the Secretary of the Treasury, with the approval of the President, promulgated the regulations now in force, under which the returns may be inspected.[51] For this purpose, corporations are divided into two classes: First, those whose securities are not advertised for sale, and second, those whose securities are either listed on the exchanges, advertised in the press, or offered for sale to the public by the corporation itself. The returns of the former are open only to the inspection of bona fide stockholders, and the latter to the public upon written application to the Secretary of the Treasury.[52]

IV.

The administrative decisions of the treasury department have transformed the federal corporation tax into a fairly consistent and fairly simple tax upon the net income accruing to corporate stockholders within the United States. By a recent unanimous decision of the Supreme Court, the act has been declared constitutional.[53] While it is possible it may be superseded by a general income tax in the near future, it is probable that the act will remain on the statute books for several years, and it is not unlikely that its main features will be incorporated into a general income tax if such a fiscal measure shall be finally adopted. It is, therefore, desirable to consider this tax as interpreted by the government on

[49] "Our association stopped the publicity required by the federal corporation tax law." *Object of Organization. Ill. Mfs. Ass'n.*, p. 2.

[50] *Treasury Decisions,* 1665, Nov. 28, 1910, p. 1.

[51] *Ibid.*, pp. 2-3.

[52] When there is any question as to whether a corporation falls in the second class, persons desiring inspection of the returns must support their application by submitting advertisements, prospectuses or other proof that the stock is offered for general sale. *Treasury Decisions,* No. 1665, p. 3.

[53] Flint vs. Stone Tracy Co. March 13, 1911.

its merits as a means of securing revenue and as an organ of federal corporate supervision and publicity.

(1) As one of the results of the increasing tendency to separate the several sources of revenue among the different taxing jurisdictions, the corporation taxes have quite generally been assigned to the states by practical administrators as well as by theoretical experts upon taxation, and, in accordance with this theory, a considerable number of American commonwealths have come to depend upon such taxes for an important part of the public revenue.[54] Furthermore the corporations, under our federal system of government, not only owe their existence to the states but also are subject to state laws and state supervision. The states therefore have looked upon the corporation taxes as theirs both by prior occupancy and by the logic of their more intimate relationship.

It is, however, becoming evident, even to the layman, that the present system of corporate supervision has been gradually breaking down and that some form of dual control, possibly on the Canadian plan,[55] must be devised in its place. When such a system of incorporation and control shall have been adopted, the *raison d'être* for the exclusive use of the corporation tax by the states will cease to exist. Then it will be natural and logical for the federal government to impose taxes upon the interstate corporations and for the several states to limit their corporate activities to the incorporation and taxation of those whose operations are strictly intra-state.

But even under the present system, the imposition of the federal corporation tax, contrary to the opinion so often expressed in Congress during the discussion, cannot possibly interfere with or supersede the present state corporation taxes. The reason for this is obvious. The law provides that all taxes paid by the corporations to any other jurisdiction may be deducted[56] before the federal tax is calculated. The several states may, then, by increasing the amount of the taxes which they severally impose upon corporations, proportionately lessen the net income upon which the federal tax is assessed. As the state corporation taxes increase,

[54] *Wealth, Debt and Taxation; Special Report of the Census Office,* pp. 617, *et seq.* (1907); *Taxation of Corporations in New England; Report of the Bureau of Corporations* (1909).

[55] The Dominion of Canada Corporation Act, Parker, *Manual of Corporations,* 1907-8, pp. 1235-1248.

[56] *Regulations,* No. 31.

the federal corporate tax must necessarily diminish in amount. The converse of this proposition is, however, not true. Furthermore, following the precedent set by New Hampshire in 1842 in the assessment and collection of the railway taxes,[57] the federal government may at any time apportion all or any part of the proceeds of the tax to the states upon some equitable plan.

(2) Business enterprises are generally at the present time organized and operated either through the individual proprietorship, the partnership, or the corporation. While theoretically the first of these forms may be assigned to the small enterprises, the second to the medium sized, and the third to the larger ones, as a matter of actual practice there is no such segregation into classes. Except at the two extremes the three forms are in constant and vigorous competition. Until the great inventions of the eighteenth and nineteenth centuries began to call for massed capital and consequently large establishments, the corporation, although antedating the Christian era, was comparatively unknown as a means of conducting business enterprises. At the present time, however, so rapid has been its development, that practically all of the public service business, the most of the banking, over seventy-five per cent of the manufacturing, and a respectable minority of the other business establishments are in the hands of corporations. In the interests of economic welfare as well as of industrial progress it is essential that the burdens of taxation should fall equitably upon each form or organization in order that business managers may feel free to choose that which is best adapted to their needs. The states, however, failing to observe this condition of progress have in many cases taxed the corporation with heavy charter fees and with annual license taxes. In addition to these state taxes, the federal corporation tax has imposed a further burden of one hundredth of the net corporate income. The corporation is thus discriminated against while the individual proprietorship and the partnership are favored. This policy will necessarily somewhat retard the normal development of the corporation and generally limit its use to the larger enterprises.[58] Until the process of adjustment is completed, the tax will favor the individual proprietorship and the partnership; after the industrial organization has adopted itself as fully as possible to the new conditions, the burden imposed by

[57] Robinson, *A History of Taxation in New Hampshire*, p. 112 *et seq.*

[58] *Chicago Tax Law Conference*, p. 29; *Journ. of Com.* (N. Y.), August 27, 1910.

the tax will fall upon the larger business establishments. From the economic point of view, there seems to be no justification for this discrimination.

(3) While the corporation tax is in form an excise tax on the privilege of conducting business under the corporate charter, it is in fact an income tax on the corporate net earnings, and therefore on the stockholders in corporations. As such it discriminates not only between corporations and other business enterprises but also between corporations engaged in the same line of work wherever their securities are not similarly arranged. Since the income absorbed by the bonds and other indebtedness is free from tax, it follows that the larger the issue of bonds and the higher the rate of interest on the same, the less the income available for the stock and the less the tax. Of two corporations, then, with the same investment, the same income and the same amount of securities, that one having the largest interest account on its bond issues will pay the smaller tax. The direct effect of the tax then will be to increase the amount paid on bonded and other indebtedness and to reduce in like measure the amount paid out in dividends or reinvested in improvements on the plant. In order that this effect should be partially checked, a provision was inserted limiting the indebtedness upon which interest may be deducted to the amount of the paid-up capital stock.[59] This provision will, however, prove of small value so long as corporations are practically free to arrange their securities and issue stock as they see fit, as they are at the present time. The above provision may be defeated either by issuing bonds bearing a high rate of interest or by inflating the capital stock account. The first method is entirely feasible for corporations having a small number of stockholders, and can easily be accomplished by the substitution of income bonds for a part of the stock. The second method will accomplish the same purpose through issuing additional stock against "good will' or accumulated surplus, thus permitting a larger issue of bonds. In either case the amount of the tax will be proportionately reduced.[60]

[59] "The limit put upon the interest deductions is therefore of fundamental practical importance. Without it the entire efficiency of the statute could easily be destroyed." Brief for the U. S. in the *Corporation Tax Cases*, p. 151.

[60] In this connection the bond conversion of the United States Steel Corporation and the re-capitalization of the Chicago and Alton Railway Co. will serve as pertinent illustrations of the process and the effects of the process upon the corporation tax.

(4) While the corporation tax was intended to fall upon the corporate income available for dividends and thus upon the stockholders while the act is continued in force, attention should be called to the incidence of the tax as between the present and the future stockholders. The imposition of a new tax upon real estate earnings, as is well known, causes an immediate fall in the market value of such real estate by the amount of the tax capitalized at the current rate of interest. The new tax thus falls upon the present holders of the real estate. The same result should follow in the case of the corporation tax.[61] The tax is thus in theory at least directly comparable to an assessment upon the corporate stockholders equal in amount to the capitalized income absorbed by the government. The actual results will not, it may be safely predicted, conform to the theory. Since the corporation pays the tax, many purchasers of stock will fail to appreciate the real conditions and consequently are likely to buy corporate securities without making the proper allowances for the new burdens thus placed upon them. So far as the real effect of the tax is taken into consideration, however, its burdens will fall upon present holders and the future purchasers will escape its burdens.

(5) The holding corporation is generally recognized to be the direct successor of the trust,[62] and as such is at the present time the most effective and the most convenient instrument for the purpose of forming and operating commercial and industrial monopolies. At the same time, however, the principle of the holding corporation is used extensively by banks, insurance companies, and other investment institutions, not for monopolizing trade and commerce but for facilitating the legitimate investment of funds. When the corporation tax bill was proposed in the Senate, it was found that under its provisions companies holding stock in other companies would be permitted to deduct dividends received from such stock, provided the companies in question were subject to the corporation tax. This exemption met opposition on the following grounds: First, the tax was an "excise upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who owned the stock."[63] Sec-

[61] Seligman "State and Local Taxation," in *Proceedings Third International Conference,* pp. 21-27.

[62] Robinson "The Holding Corporation," *Yale Review,* Feb., May, 1910.

[63] *Cong. Rec.,* 44:4231. The words quoted were those used by President Taft in his special message on the corporation tax, June 16, 1909.

ond, the tax should be used to discourage monopolistic holding corporations formed for the purpose of "dominating and monopolizing the business of the country."[64] In answer to the first contention it was openly admitted by Senator Aldrich that the tax, while nominally upon the privilege of doing business in the corporate form, was in reality a tax upon income.[65] He therefore argued that a tax upon the income of the holding corporation would constitute double taxation, and, consequently, should be disapproved. In this he was supported by the representatives of the savings banks and the insurance companies, both of which classes of institutions invest largely in corporation securities. In this connection it was pointed out that only a small portion of the securities owned by holding corporations are held for purposes of monopolizing business. To tax the income of monopolistic holding companies and exempt the non-monopolistic holding companies[66] was considered impossible, and to tax both would impose unnecessary and unjustified hardships upon legitimate business. Congress, therefore, decided to be inconsistent rather than unjust, and accordingly the holding corporation, irrespective of its monopoly power, was exempted from the tax so far as its income is derived from dividends on the securities [67] which it holds. The holding corporation was, however, required to make the regular returns.[68]

(6) Insurance companies whether organized upon the stock or mutual plan are taxed upon the excess of the premium income over the costs of conducting the business, including in the latter the additions required by law to be made to the reserve funds. The inclusion of insurance companies was criticized in the Senate on the ground that, first, insurance companies are not profit earning enterprises, and second, that those operating under the lodge sys-

[64] Senator Clapp, *Cong. Rec.*, 44:4229.

[65] Mr. Aldrich: "What is the use of playing upon words. I want to know whether an income tax is not a tax of the same kind, paying out of the same fund upon the profits? It makes no difference what you call it. It is only a question of words. The Senator from Iowa may say this is an income tax. I may say it is a corporation tax. Another may say it is a tax upon earnings. Another may say that it is an excise tax. You may characterize it as you please, it is a precise duplication. The Senator from Iowa and the Senator from Texas recognized the equity in that case and made the same exemptions that are made under the proposition that comes from the President and is recommended by the administration." *Cong. Rec.*, 44:4232.

[66] *Cong. Rec.*, 44:4233. This plan was advocated by Senator Newlands.

[67] *Regulations*, No. 31, p. 3.

[68] *Treasury Decisions*, No. 1606, p. 2.

tem, and indeed all other mutual business organizations, were exempt from the tax. The real purpose in including the insurance companies does not appear upon the surface. It was, however, not an oversight. Senator Bulkeley of Connecticut inquired at the outset whether it was the intention of the bill to include purely mutual insurance companies, and Senator Flint in charge of the bill replied in the affirmative.[69] Thereupon an amendment was offered to exempt "mutual companies and corporations transacting business upon the mutual plan wholly for the benefit of the mutual policy holders"[70] and promptly voted down without debate by the usual majority.

If the insurance tax had been imposed upon the corporate profits of insurance companies operating on the stock plan, its theory, as well as its economic effects, would have been comparable to that underlying the main portion of the act. The inclusion of purely mutual insurance societies can, however, hardly be defended from either the economic or the fiscal point of view. Insurance companies are not profit-making but loss-sharing institutions. They do not serve to increase the store of useful goods in the world, but to transfer the burdens due to losses from the few to the many. Such institutions require governmental supervision and it is entirely proper to impose upon them the legitimate costs necessitated by such supervision. To tax insurance companies over and above the cost of supervision is, however, a serious economic error. Moreover the insurance business is already loaded down with taxes of all kinds and the burden is rapidly growing.[71] Under these conditions it is reasonable to suppose that the administration and the Republican majority in Congress were in favor of including the tax upon the insurance business for the sake of the revenue, and consequently other motives must be sought.

It is a well-known fact that the federal government has for the past decade been trying to devise a feasible plan for the establishment and exercise of governmental control and supervision over the larger financial institutions. It has exercised such control over the national banks since their establishment during the civil war.

[69] *Cong. Rec.*, 44:3339.

[70] *Cong. Rec.*, 44:4236.

[71] Hoffman, "The Tax Burden on Life Insurance Policy Holders," in *State and Local Taxation. Third International Conference*, p. 149 *et seq.*; Zartmann "Necessity for Reform in Life Insurance Taxation," *Yale Readings in Insurance*, p. 363 *et seq.*

The Industrial Commission gave considerable attention to the subject[72] of the relation of the government to the larger corporations, and published among other papers a comprehensive discussion by the late Professor Huffcut upon the constitutional aspects of the federal control of corporations.[73] The annual report of the Commission of Corporations for 1904 prepared a plan for exercising a larger degree of federal supervision, and in 1909 the powers of the Interstate Commerce Commission were considerably enlarged. While the authority of the government was thus being extended in other fields, the insurance companies remained free from any kind of federal control and supervision. The federal corporation tax presented the opportunity to the government; it was eagerly grasped and the tax on insurance companies was the result. The efficiency of this method of federal supervision will be discussed in a succeeding section.[74]

(7) As introduced into the Senate the act provided for a tax of two per cent upon the net income of all profit earning corporations. When the measure was under consideration by the ways and means committee of the House it was estimated that the two per cent rate would yield an income of approximately $25,000,000.[75] As a result of further investigation it was found that the original estimate would probably exceed $60,000,000. As the revenue was intended to supplement the customs revenue rather than supplant it, the rate was reduced to one per cent.[76] The revised estimate proved to be an exceedingly correct one. The actual assessment for the first year was $27,290,767.43 and in addition about $125,000 was collected in the form of penalties, chiefly from corporations that delayed paying the tax on the specified date in the hope that the act would be declared unconstitutional.

The administration of the tax is under the general control of the Commissioner of Internal Revenue, and is assessed and collected through the regular organization of that office. As no attempt seems to have been made to apportion the general expenses of the

[72] *Report of the Industrial Commission,* 1:1123 *et seq.*

[73] *Ibid.,* p. 1211, *et seq.*

[74] Hoffman, *International Tax Conference, 1909,* p. 156: "If the United States Congress has not the power to supervise or regulate insurance companies, then it would seem a grave abuse of the taxing power of the constitution to use the same to attain an end which is otherwise held to be unconstitutional."

[75] Longworth, *Cong. Rec.,* 44:4720.

[76] *Cong. Rec.,* 44:4720.

office among the various taxes assessed and collected, no accurate statement can be made regarding the actual cost of collecting the corporation tax. For the first year a small appropriation was made for this purpose, and for the second year the Commissioner submitted an estimate for $100,000 for collecting the tax and $25,000 for classifying and filing the returns.[77] This estimate, however, gives no additional information upon this point, since the salaries of the collectors and the general expenses of the office are provided for in the regular appropriations. Upon the whole the Commissioner states "the tax has been collected with as little difficulty and friction as has been occasioned by the collection of any internal revenue tax."[78]

(8) The corporation tax law should not, however, be judged primarily upon its capacity to produce revenue or to distribute the fiscal burdens equitably. Its important function in the view of its sponsors was to give publicity and to furnish the basis of governmental supervision of corporations. In his message of June 16, 1909, the President warmly commended this feature of the act.[79] Senator Flint who had charge of the measure in the Senate stated that by reason of its provisions "the public will be advised of the condition of affairs of corporations throughout the country."[80] Senator Root argued that the "systematized information, not too bulky, not in too great mass for anybody to even get anything out of it, but so arranged as to contain the essentials, leaving out the mass of non-essentials, and renewed from year to year" would enable the government of the United States to "take a great and necessary step forward" in the efficient performance of its duties in administration and legislation.[81]

It has already been pointed out that by the latest decisions of the Treasury Department, approved by the President, November 28, 1910, the corporation tax returns can be inspected only in Washington, and even there only in case of those corporations whose securities are offered to the public for sale. This restriction narrowly limits the publicity feature so far as the general public is concerned. Suppose, however, an interested party should visit

[77] *Annual Report of the Commissioner of Internal Revenue for the year ending June 30, 1910,* p. 6.

[78] *Ibid.,* p. 13.

[79] *Senate Document,* No. 98. 61 Cong., 1 sess.

[80] *Cong. Rec.,* 44:3937.

[81] *Cong. Rec.,* 44:4006.

Washington for the purpose of inspecting the returns, what information could be obtain? Obviously that furnished by the various corporations on the regular blank prepared by the Commissioner of Internal Revenue for the purpose of assessing the tax. The character of the returns is strictly determined by the law, and the framers of the law in their desire to guard against irregular practice, and to secure what they deemed the necessary information only, provided for an exceedingly meager and incomplete form of return. To show the character of the information available, the reports of the following corporations have been collected and arranged in tabular form:

	Am. Sugar Ref. Co.	International Harvester Co.	Amalgam. Copper Co.	Am. Tobacco Co.
Stock	$90,000,000	$120,000,000	$153,887,900	$118,931,500
Bonds	4,719,689	9,925,000	50,370	105,175,550
Gross Income.....	11,783,392	19,248,255	5,037,381	41,840,249
Deductions:				
Expenses	2,207,319	143,492	94,086	10,190,663
Losses	4,913,070	1,110,442	0	115,849
Depreciation	995,944	557,765	0	623,277
Interest	131,656	489,056	0	5,355,330
Taxes	123,925	228,091	11,444	437,459
Dividends	4,119,201	1,022,594	4,465,388	14,984,684
Total	12,491,118	3,551,440	4,570,988	31,707,233
Net Income.....	707,725*	15,696,815	466,462	10,133,015

* Loss.

It is evident upon inspection of the above table that in case of those corporations whose returns can be seen, at least three other sources of information, which combined are generally superior in character to that of the government returns, are available. These sources are: First, the annual reports of the respective corporations; second, statements published in the investment manuals, and third, the reports of the corporations to the stock exchanges on listing their securities for public sale. In this connection it hardly needs to be stated that nothing less complete and definite than a properly drawn up and carefully itemized balance sheet and income account would ordinarily be offered to an intelligent and discriminating investor by a corporation desiring his patronage or financial support, and that nothing less complete than this should

be required by the government if the primary purpose of the fact is to secure publicity of corporate finances.

(9) But those who originated and supported the corporation tax had other interests than the individual investor in view. The federal government would, it was thought, be able to use the returns for the purposes of legislation and administrative supervision. Both Senator Root and Mr. Longworth strongly intimated that the tax returns would enable Congress to discriminate between prosperous and struggling industries when the tariff was under revision.[82] The former asserted that "garbled and partial" statements were presented by corporations asking for protection and that the members of Congress had "no means of distinguishing the truth." Mr. Longworth thought the act "at least one step in the solution of one of the most important questions that is before the American people, the question of the reasonable regulation of corporations."[83] He further asserted that as a result of the publicity provided by the act, "millions of the public's money will come out of hiding and seek investment in corporate stock and floods of money will come to this country from foreign investors."

It is, of course, quite absurd to expect any such marvelous results to follow from the meager information given by the returns of the corporation tax, stored in the government vaults at Washington. Those Congressmen who supported the tariff of 1909 in the face of the available information then offered them, are not likely to be affected by reports made for taxation purposes, even though they are made under oath. The publicity feature of the corporation tax, however, should be viewed in quite a different light. While it will be admitted by all serious students of corporation finance that the present reports are inadequate and fragmentary, it should not be forgotten that the federal government is an apt pupil and that the present law is likely to be amended in the future or extended by administrative regulations and always for the purpose of securing fuller and more adequate returns. The federal corporation tax law, then, must be regarded not as in its final form, but as a first step in the federal supervision

[82] "I should like to see in the office of the Commissioner of Internal Revenue the next time a tariff bill comes before Congress a statement, under oath, and tested year by year, about the business of this vast multitude of corporations that come appealing to us here for help, so that we shall not again be compelled to come to the conclusion that all the business in the United States is on the brink of ruin." Senator Root, *Cong. Rec.*, 44:4007.

[83] *Cong. Rec.*, 44:4720.

of those corporations that are in reality conducting an interstate business.

(10) In addition to the information furnished to the corporate stockholders the general public and the government, through the individual returns of the several corporations, some new light upon the extent of corporate development and the relations of earnings to capital stock may be found in the annual report of the Commissioner of Internal Revenue for the year 1910. For statistical purposes corporations are divided into five classes as follows: Class A, Financial, including insurance, building and loan associations, etc.; Class B, Public Service; Class C, Manufacturing and Mining; Class D, Mercantile; Class E, Miscellaneous, including hotels, theatres, contractors, etc. From this report the following table has been arranged.

STOCK, BONDS AND INCOME BY CLASSES OF CORPORATIONS

Corporations			Capital Stock*		Bonds*		Net Income*		
Class	No.	%	Amt.	%	Amt.	%	Amt.	%	Return on Stock
A. Financial	29,812	11.3	2,724	5.2	2,404	7.6	394	12.6	14.4%
B. Pub. Service	24,252	9.2	18,902	36.1	17,472	55.7	809	25.9	4.2 "
C. Manf. Mining	89,384	34.0	21,586	41.3	7,019	22.4	1,326	42.4	6.1 "
D. Mercantile	54,673	20.8	2,971	5.6	1,783	5.7	360	11.4	12.1 "
E. Miscellaneous	64,359	24.5	6,088	11.6	2,655	8.4	236	7.5	3.8 "
All classes	262,490	100.	52,371	100.	31,333	100.	3,125	100.	5.9 "

*Capital Stock, Bonds and Income in millions of dollars.

The statistical data from the annual report, condensed in the foregoing table, is the first accurate information which has been furnished students of the subject showing the number of corporations in the United States, the amount of corporate securities and of corporate earnings. The classification, while too comprehensive to admit of accurate comparison, is based upon logical principles, and therefore may serve to show certain general tendencies and conditions of fundamental importance.

In the first place, it will be noticed that the public service business is primarily the field of the large corporation. Comprising less than 10 per cent of the corporations in the United States, this group had over 36 per cent of the corporate stock, nearly 56 per cent of the corporate bonds, and is credited with 26 per cent of the net corporate income available for dividends. The average capital stock per corporation in this group is $780,000. The

mercantile business, on the other hand, is the home of the small corporation. This group, comprising 21 per cent of the corporations, has less than 6 per cent of the corporate stock, and earns only 11 per cent of the net corporate income. The average amount of capital stock per corporation in groups A, financial, and E, miscellaneous, is $95,000 and $94,000 respectively. That of group C, manufacturing and mining, is somewhat above the average for all corporations in the United States, or about $240,000 per corporation.

In the second place, the earnings on capital stock show wide variation from class to class. Class A leads the list with over 14 per cent, class D is second with an average of 12 per cent. Manufacturing and mining corporations occupy a middle position, and classes B and E, public service and miscellaneous, yield the low return of 4.2 per cent and 3.8 per cent respectively.

In view of the well-known tendency of capital to flow from industries yielding low returns to those yielding high returns, with the consequent leveling of the rate of earnings, this marked variation calls for explanation. While it is impossible with the data at hand to completely account for this difference in apparent earning power, the following facts are clear:

(1) It is generally conceded that public service corporations are over-capitalized and the same may be said of many manufacturing and mining enterprises. The banks and mercantile business houses, on the other hand, are generally capitalized on an exceedingly conservative basis. For example, the capital, surplus and profits of the national banks in the United States on March 7, 1911, were reported as follows:

Capital stock	$1,011,570,324
Surplus	665,772,553
Undivided profits	232,447,742
Total	$2,009,740,619

The total capital stock in class A, including national banks, private banks, trust companies, insurance companies, etc., amounted to only $2,723,954,539.09 in 1910. Furthermore many of the insurance companies have no capital stock to swell the amount. On the other hand, on account of the policy of life insurance companies of charging a premium somewhat above that which is required for conducting the business, they were able to pay dividends and accumulate a surplus, which increases the earning

attributed to this group. Consequently group A has a relatively small amount of capital stock and a relatively large amount of net earnings. This makes the apparent earnings larger than would otherwise be the case.

(2) The holding corporations are quite generally found in classes B and C. As their securities are included in the amount of capital stock while their earnings are excluded from the corresponding income column the apparent earning power of these two classes is much below their real earning power. If the real assets behind the corporation stock in each class were known, it is entirely probable that the rates of profits in the several classes would be much more nearly equal than appears upon the face of the returns.

As the corporation returns are also reported by states, the following table is added to show the relative position of the several jurisdictions.

CORPORATIONS, CORPORATE SECURITIES AND INCOME BY STATES

State	Rank	No.	Stock*	Bonds*	Net Income*	Return on Stock
New York	1	31,132	$10,734	$7,834	$646	6.0%
Penna.	2	18,362	5,496	2,669	374	6.7 "
Illinois	3	17,908	3,191	3,032	274	8.6 "
Ohio	4	14,294	2,046	1,080	186	9.1 "
New Jersey	5	8,403	3,149	1,754	165	5.2 "
Total**		90,099	24,618	16,369	1,645	6.6 "
All others		172,391	27,753	14,964	1,480	5.3 "
Total		262,490	52,371	31,333	3,125	5.9 "

*Stock, bonds and income in millions of dollars.
**Five states.

It will be noticed that five states, namely, New York, Pennsylvania, Illinois, Ohio and New Jersey, returned somewhat less than one third of the entire number of corporations and somewhat over one half of the entire amount of net earnings. In this connection it should be noticed that each corporation is required to report from the state in which its books of account, from which the report is made up, are kept. Consequently the above table does not necessarily show the corporate earning power of the corporations operating in the several states, but the relative rank of the states on the basis of the general accounting offices of the various corporations. It is however probably true that in most cases the office where the principal books of account are kept corresponds

with the principal seat of operations, and therefore the table is fairly representative of the corporate activities in the several states.

As a necessary result of the provisions of the act, the Commissioner of Internal Revenue has collected and holds in the government archives a mass of valuable data relating to corporations and their finances in the United States. These data are at the present time absolutely useless. By the collection of this information, however, an opportunity has been presented to the government for the publication of the important facts regarding corporate development in various fields of industrial activity. Apparently this opportunity has not yet been appreciated by the federal administration. It is to be hoped that this vast storehouse of information will not long be allowed to lie idle, but, under the direction of trained economic statisticians, will be published to the world.

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